TAX TALKS

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How to avoid s109T – you might not even know this is an issue you have.

How To Avoid s109T

s109T is an issue when the recipient of a Div 7A loan isn't a shareholder but minimum yearly repayments are financed via a dividend.

How to avoid s109T in this triangular set-up? This is the question Geoff Stein of Brown Wright Stein Lawyers in Sydney will discuss with you in this episode.

Here is what we learned but please listen in as Geoff explains all this much better than we ever could.

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How To Avoid s109T

Let's say you have a cashed-up, highly profitable company with a pre-CGT capital gain. You don't want to declare a dividend for this pre-CGT capital gain, because then you pay marginal tax rates on something that was supposed to be tax-free. So you take the cash out by making a Div 7A loan.

But you don't make this Div 7A loan to the shareholder but to another related entity, let's say a trust. And this trust takes the cash, invests it in property and registers a Div 7A mortgage on this property.

So far all is well. No issue.

But now the trust needs to make minimum yearly repayments. And this is where the problem starts. The trust has no cash. The cash is all tied up in the property.

So you get the company to declare a dividend to the shareholder, which is then offset with the minimum yearly repayments. Except…it isn't. You can't offset because there is no mutual obligation. The company has no obligation to the trust. And this is where you run into s109T.

But there is a way around s109T. And this is how.

Payment

The first thing you need to get right is payment. The dividend must be paid by 30 June. The minimum yearly repayments must be paid by 30 June.

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If you have the necessary liquidity (or find a bank manager who is happy to do all three payments in one virtual second), you can just pay everything in cash. You pay the dividend and subsequent gift as well as the minimum yearly repayment by bank transfer. That would solve the problem.

But you often don’t have the necessary liquidity. And so instead you do these payments by cheque or promissory note instead. You could also assign an asset.

It doesn’t matter how you pay, as long as you pay.

A word of caution: While issuing a cheque legally is the same as issuing a promissory note, the tax office does not like the issue of promissory notes because it has an artificial smell to it. But if the company doesn’t have a cheque book, then a promissory note is all you got, unless you want to assign an asset.

Documentation

The second thing you need to get right is documentation. To make your work around s109T legally effective, you need documentation. A journal entry is not enough. The journal doesn’t create a transaction. It just tries to reflect a transaction, which might or might not exist.

And so you need to correctly document the minutes or resolution to declare the dividend and mark it in the company register, followed by the issue of a dividend statement.

And you need to document the gift the shareholder makes to the trust. In theory, the shareholder could make it a loan and not a gift. But a loan would create an asset in the hands of the shareholder which creditors could go after in bankruptcy (or family court) proceedings. So a gift is usually preferred.

Merry Go Around

And so now you do a merry-go-around that will clear you of s109T.

The company declares a dividend to the shareholder and pays this dividend by issuing a cheque or promissory note or some other form of debt that can be signed or assignment of an asset.

The individual shareholder receives the cheque or promissory note or assignment and endorses it to the trust as a gift.

The trust receives the cheque or promissory note and endorses it to the company as the relevant minimum yearly repayment. And this completes the triangle.

Summary

So you safely use dividends for minimum yearly repayments in a triangular Div 7A set up – clear of s109T – in 8 simple steps.

1 – You calculate the minimum yearly repayments by 30 June.
2 – The company declares a dividend for that amount by 30 June.
3 – The company pays the dividend by issuing a cheque / note by 30 June.
4 – The shareholder endorses the cheque / note to the trust by 30 June.
5 – The shareholder documents the gift or loan by 30 June.
6 – The trust endorses the cheque / note to the company by 30 June.
7 – The company directors register the relevant minutes / resolution by 31 July.
8 – The company directors issue a dividend statement by 31 October.

ATO

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The ATO rarely (never say never) comes knocking just because of s109T. After all, this transaction by journal entry and shortcut on paperwork is very common. Most accountants are not even aware of s109T.

But s109T does come up. And it usually comes up in controversial audit situations. The auditor has raised a long list of grievances. And then s109T gets added to the mix.

And when it does, it is you as the accountant who booked it this way, who is left carrying the blame and whatever financial penalties come with that.

MORE

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